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MEMORANDUM

December 23, 1980

TO : ALL NEA OFFICE DIRECTORS
NEA/RA

FROM : NEA - J. W. Twinam

SUBJECT: U.S. Economic Interests in NEA

I have attached for your information a copy of the transition paper the bureau submitted on U.S. economic interests in the NEA region, together with supporting background papers prepared by the Economic Staff on U.S. commercial interests, energy, financial implications, and U.S. assistance to the region. You may want to discuss these papers with the Economic Staff. We are considering sending them out by cable to the posts.

Attachments: (5)

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US Economic Interests in the Near East and South Asia

The Issues

Fostering major US economic and commercial interests in the Near East and South Asia is an important aspect of our overall policy toward the region. The environment in which we seek cooperation with Middle East oil and money powers and in which our private sector seeks markets is significantly determined by the progress of other aspects of our relationships, notably the Middle East peace issue and the region's security situation.

Success in pursuing our economic interests has significant impact on the health of the US economy and our ability to sustain a global strategic role. The specific economic and commercial issues which we face in the Middle East and South Asia are more often than not economic policy questions of broader international and domestic import, making it difficult to think in terms of a comprehensive foreign economic policy toward the region per se.

Finally, it is important to flag the economic impact of the enormous resource requirements for maintaining our strategic position in the region.

The Commercial Interests

Nearly 10% of US exports, about \$16 billion annually, now go to the Near East and South Asia. In the lead markets, Saudi Arabia, Israel, and Egypt, we hold a 1/5 share with healthy shares in Pakistan, India, and some of the Persian Gulf states. The Iranian revolution and our trade sanctions in the wake of the seizure of the hostages have closed that once major market for US goods and caused our overall market share in the Middle East to fall somewhat over the last few years. US companies earn about \$5 billion a year in providing petroleum, construction, financial, and other services in the areas, again largely in Saudi Arabia and the Persian Gulf. These non-military goods and services offset some 2/3 of our import bill for Middle East oil.

A strong US commercial presence in the region is of obvious benefit to the well-being of our own economy, which in turn

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impacts significantly on our ability to maintain a strong strategic posture in the region and elsewhere. Close commercial ties provide a key asset for building strong overall relations with Middle East states and for maintaining some position with them in times of political stress. The activities of US Government and business in providing technology for the development of Middle East societies play an important though difficult to measure role in promoting orderly development in a turbulent region.

The Specific Issues

There is a persistent view among US businessmen dealing with the Middle East that US laws and policies place them at commercial disadvantage with competitors from the other industrial democracies. They cite among the main "disincentives":

- US taxation of the foreign earnings of Americans working abroad;
- The ambiguities of the Foreign Corrupt Practices Act;
- US anti-boycott legislation;
- Foreign policy controls on exports to countries identified as supporting terrorism;
- Restrictions on US Government insurance in ten high income countries in the region; and
- Relatively uncompetitive Export-Import Bank financing.

Cooperation in Oil and Money

The Middle East and North African producers control 72% of the free world's estimated proven oil reserves, 52% of free world production, and 45% of total US imports of crude oil and products, as well as 70% of Japan's imports and 73% of Western Europe's. The vital strategic aspect of Middle East oil is obvious, and continued US access to it is closely related to regional security and political questions, including the Arab-Israeli conflict. Short of politically motivated supply disruption, however, the supply and price of Middle East oil have a critical impact on the welfare of

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the international economy, and our own. In this decade we face a particularly difficult situation in that these Middle East producers with greatest production capacity--notably Saudi Arabia but also Iran, Iraq, Kuwait, and Abu Dhabi--need for domestic economic development less income than their producing at full capacity would provide. Because Saudi Arabia, Kuwait, and Abu Dhabi--and Iraq before the present conflict with Iran--have been willing to produce more oil than their income needs require, they have accumulated over \$250 billion in official foreign assets. They have become a significant force in international finance and investment and in international development lending.

It is in the US interest to maintain and build on a sense of common interest with the Middle East producers in the welfare of the international economy. It is in the US interest that these producers:

- maintain adequate production in the face of strong domestic conservationist pressures to reduce production;
- restrain the rise in oil price;
- maintain constructive investment policies supporting the stability of the dollar and other major currencies; and
- contribute an even larger than present share of their surplus income to meeting the balance of payments and development needs of the poorer countries, both bilaterally and through regional and international institutions.

The Issue

The US is in the early stages of a dialogue with Saudi Arabia, and to a lesser degree Kuwait and Abu Dhabi, on the relationship of energy to international financial and development issues. The development of this dialogue will be central to any effective strategy for dealing with a growing international demand for a consumer/producer dialogue on some or all of the issues at the heart of the "North-South issue". It is already quite clear that Saudi Arabia and other producers presently well disposed toward cooperation with the US and other industrial democracies look to the US to make certain major contributions in any cooperative effort to deal with the transition to an era of less dependence on imported oil. These include:

- A US energy program further reducing dependence on foreign oil;
- Sustained reduction of US inflation rates;

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- Long-term stability of the dollar;
- Greater contribution by the US and other industrial democracies to the economic development of the poorer countries;
- Sustained efforts to transfer technology to the oil producers, including assisting in the development of viable petrochemical industry; and
- Providing a more hospitable climate for investment of the producers' surplus income, with reasonable assurance of the security and maintenance of value of such investment.

This range of economic issues, having a scope well beyond our relations with particular Middle East countries, cannot be dealt with as a unit. In the months ahead, however, as the US deals with these issues in a variety of policy processes it is important to keep in focus that they are from the core of our economic relationships with the wealthy Middle East oil states. The extent to which our policy deals with these issues in a way which the Middle East producers consider compatible with their own interests will, in large part, determine the degree of cooperation we can expect of them in oil and money questions.

The Economic Cost of Pursuing Our Interests in the Near East and South Asia

The pursuit of major strategic and military interests in the region bears a heavy resource burden. There is the massive redirection of defense spending to provide greater capability to deal with Middle East contingencies, often estimated in the \$20-30 billion range. US efforts to date to bolster the security, the economic order, and the will to peace of key states in the region have made this part of the world the major recipient of US economic assistance. Middle Eastern states, primarily Israel and Egypt, receive some 80% of our total Economic Support Fund allocations. Over half of our worldwide PL-480 Title I food aid goes to the region, largely to Egypt. Some 17% of our development assistance goes to the area, but we are in addition a major supporter of international financial institutions which provide even larger development aid to key area states, notably India. In addition, a large portion of our foreign

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military sales credits are in this part of the world, again heavily concentrated on Israel and Egypt and with significant impact because of the grant element in our military assistance to Israel.

In the next few years the demand for greater US resources for the region will intensify. The Egyptian and Israeli economic situations stimulate pressures for greater US aid. Our efforts to encourage more aid from rich Middle East states for strategically important countries such as Pakistan and Turkey, although often successful, are met by counter-pressures that we do more ourselves. As we develop US policy toward the region in the months ahead, it is essential that we be prepared to make available the economic resources necessary to sustain our policy initiatives.

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Commercial Interests

A strong U.S. commercial presence in the region provides a firm foundation for overall relationships, a key asset on which to build in periods of general political harmony with the region and a safety net in time of political stress. Close economic relations would also assure a strong U.S. role in shaping the evolution of Middle Eastern societies in the unstable period ahead. Moreover, vigorous pursuit of U.S. commercial interests is vital to preserving our own economic well-being which is central to world economic and, consequently, political stability.

Near East/South Asian countries represent large and important markets. Our trade and commercial interests are substantial in these countries which are pursuing extensive development programs. In 1979 about 9% of our exports were sold to the NEA area, amounting to almost \$16 billion and providing one-half million jobs to the U.S. economy. Our principal export markets were Saudi Arabia, Israel, and Egypt, in each of which U.S. suppliers accounted for about one-fifth of the market. Saudi Arabia is by far our largest market in the NEA area and the seventh largest in the world for the U.S. We also have good shares of the import markets of Pakistan, India, and some of the Persian Gulf countries. With the revolution and imposition of trade sanctions in Iran, however, our exports to that formerly important market have ceased.

In addition to our exports of merchandise, U.S. companies earn about \$5 billion for the construction, maintenance, and financial services they provide and from the repatriated profits of American oil companies. Our large earnings from the sale of goods to NEA countries were offset by almost \$30 billion in purchases, mainly oil, which created a merchandise trade deficit with the area of almost \$14 billion in 1979. In most recent years, however, our earnings from services and massive capital inflows from these countries to the U.S. have offset even this deficit.

New contracts for projects and other goods and services awarded by Middle East countries amount to \$40 billion each year. Although the Iran/Iraq war has had some negative impact, the Middle East will remain an important export market as Arab oil revenue continues to increase. Despite our need for a strong and active economic role in this lucrative and politically important area of the world, a recent study indicated that the U.S. share of exports to Middle East markets has fallen by over five percentage points since 1977. This is contrary to the trend of U.S. exports to the rest of the world where our market share increased markedly following the fall in the exchange rate of the dollar. Our relatively larger commercial losses in Iran are only part of the reason for our poor showing.

The Arab countries have surpassed the U.S. as the largest market for West European exports and the Europeans appear to be picking up a portion of our market share in the Middle East. Our interests in the Middle East, however, are not always served by our allies. We also pay a heavy economic price for lost commercial opportunities which, over time, will detract from our ability to achieve our strategic objectives.

The deterioration in our position in the Middle East has been traced by many business groups to the export "disincentives" which the U.S. has placed in their way. These disincentives have a particularly negative impact on U.S. commercial interests in NEA countries. Close economic ties with Arab countries are, of course, also hampered by Arab unhappiness with our policies toward Israel. However, Arab economic reprisals against the U.S. are surprisingly rare when compared to the damage inflicted by our own legislative and policy constraints, such as:

- highly restrictive U.S. anti-boycott laws which discourage many small and medium-sized U.S. companies from even entering the NEA market and hamstringing the efforts of other companies to deal with boycott problems;
- threatening and ambiguous anti-corrupt practices statutes force many firms to be overly cautious in dealing with their own agents and with gifts and other payments necessary to do business in the Middle East;
- U.S. taxes on overseas Americans which are eroding our private commercial presence in the Middle East;
- foreign policy controls on exports to designated "terrorist" countries which are particularly damaging to our civil aircraft sales;
- restrictions which prohibit the issuance of U.S. government insurance by OPIC in ten NEA countries which have a high per capita GNP;
- less than competitive export financing from EXIM.

Easing or improving these restrictions would not require major new legislative efforts. Legislation is pending which would clarify and ease U.S. corrupt practices laws, substantially lower the taxation of overseas Americans, and lift the restrictions on the government issuance of risk insurance. At the same time, more liberal interpretations of existing anti-boycott statutes and foreign policy controls would significantly ease these constraints. A more competitive spirit at EXIM and more funding for loans would reduce the financing barriers to more U.S. sales.

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Middle East and North African Oil

Issues and US Interests

Middle East and North African nations possess 72% of the Free World's estimated proven oil reserves. In 1979 they accounted for 52% of Free World oil production, 46% of total US imports of crude oil and refined products, 70% of Japan's imports and 73% of Western Europe's. In the first four months of 1980, they provided 51%, some 3 million barrels daily (MMBD), of total US crude oil imports of 5.9 MMBD.

The dependence of the United States and its major allies on Middle East and North African oil is expected to be the same or greater in 1985. Only the more optimistic scenarios on development of alternatives suggest some decline in our dependence on the region by 1990.

This dependence--renders us vulnerable to major economic shocks--produces strains in our alliances--is at the heart of the region's strategic importance to us, is intimately related in the minds of producer nations to the Arab-Israeli issue--is at the center of other key international economic issues, including the healthy functioning of developed and developing economies, the stability of the international economic system as a whole, the problem of adequate recycling of funds, especially to higher-risk developing countries, and the Global Negotiations.

Key US interests include:

- adequate supplies of oil from the region;
- price restraint;
- investment in additional production capacity; and
- responsible use of the producer's growing financial power.

Oil and Regional Stability

The region has provided adequate supplies of oil to the world, except when disruption has occurred in consequence

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of regional conflict or upheaval. The 1973 production cuts and embargo arose from the October War. In 1978-79, supplies from Iran were disrupted by the revolutionary process. This fall, the war between Iraq and Iran has disrupted supplies from both countries.

While details differed, in each of the first two cases an initial disruption provoked by a political crisis set in motion market forces, notably including a market psychology of great uncertainty, that took over and did the rest: panic buying drove spot prices to unprecedented levels, prices for term contracts followed, and OPEC official prices were then raised. It is only a slight exaggeration to say that OPEC simply gave formal blessing to what had occurred through no design of its own. During the quieter period of 1974-78, real prices of OPEC crudes fell almost continuously. Blessed with record high oil stocks, we and our partners in the International Energy Agency are currently encouraging stock draw and discouraging recourse to the spot market in an attempt to prevent a reenactment of this scenario.

The problem of assuring adequate supplies, then, is first and foremost the problem of nurturing regional stability, of searching for ways to reduce or avoid heightening tensions in the region that are the source of instability. From the economic perspective the grave effects of past disruptions and potentially devastating effects of future ones make this problem a major priority of US foreign policy.

The region's oil-producing states view the Arab-Israeli conflict as the principal source of tension in the area. The Iranian revolution, however, has sharpened their awareness of internal sources of tension: the strains caused by rapid economic development in traditional societies, the discontent of groups who feel they are denied their rightful participation in national life, or doubts about ruling groups' honesty and competence in defending the national interest, which can erode legitimacy. In small Gulf states that are host to significant numbers of expatriate Palestinians, the Arab-Israeli conflict has become an internalized source of tension. Similarly the Iranian revolution, viewed with uneasiness by all its neighbors, is perceived as the source of an internal threat in countries or regions that have substantial Shi'a populations, notably Iraq, Bahrain, and the Eastern Province of Saudi Arabia.

Perceptions of a Soviet threat to regional stability, though heightened by the Soviet invasion of Afghanistan, remain

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The Arab-Israeli conflict continues to color all aspects of our relations with the region's oil producers, from the friendliest nation to the most hostile. To reduce the risk of future disruptions of oil supplies, we must find constructive ways to address not only this issue but major sources of tension in the region.

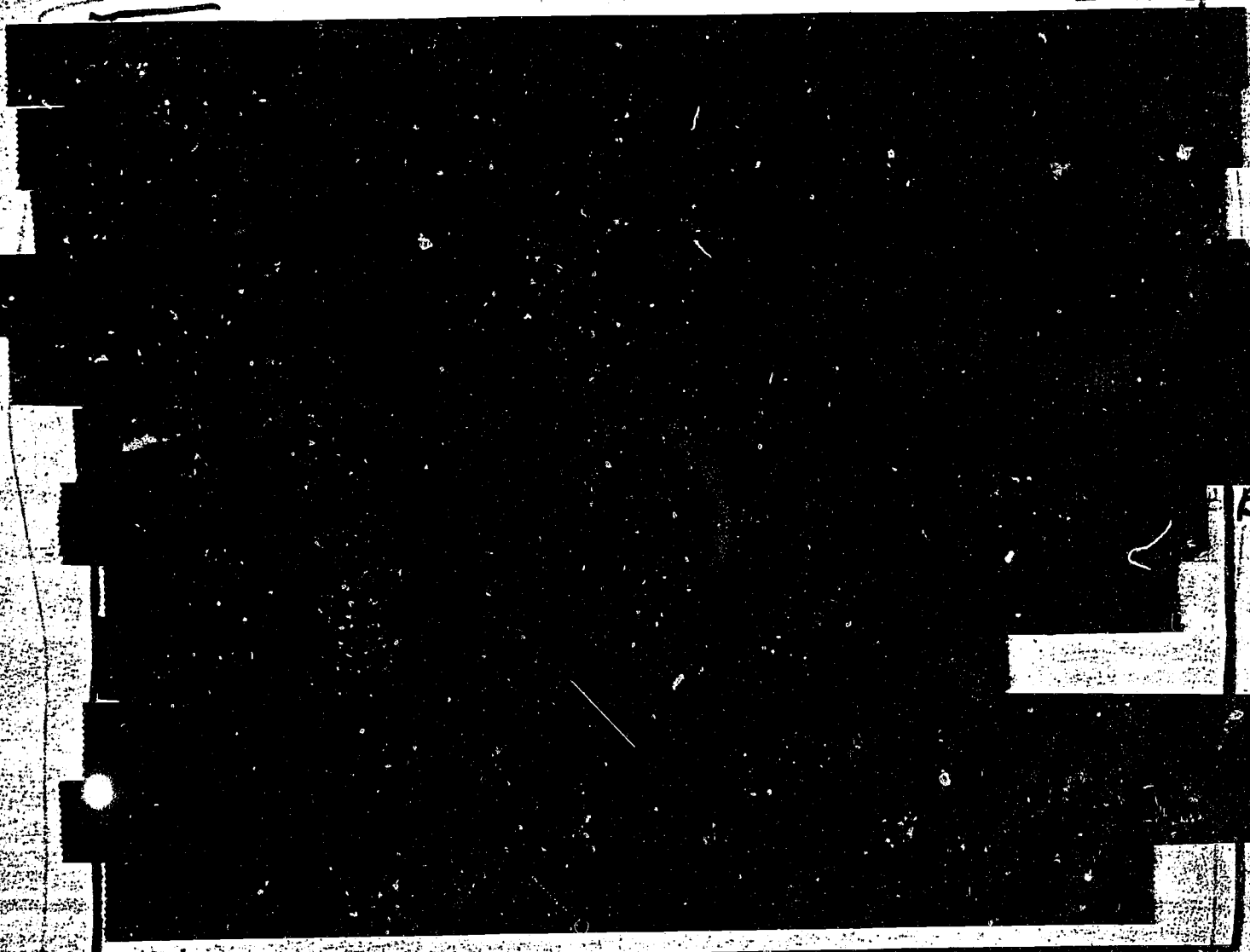
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Means and Methods

The Economic Issues

Middle East and North African producers hold immense economic power. In a moderately tight oil market, of the sort we are likely to face during most of the next 5-10 years, almost any of the larger of these producers could, if it chose, reduce production over a period of months, and provoke price increases sufficiently large to increase, in the end, its total revenues. This is true even of Algeria, Libya, Iran, Kuwait, and Abu Dhabi, to say nothing of Saudi Arabia. The 1982 "miniglut" predicted by Saudi Petroleum Minister Yamani would provide at best a brief respite from this situation (in the sense that enough spare capacity may exist to compensate for a reduction in supplies from one source).

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The Oil Weapon and the Arab-Israeli Problem

-- the concern of the conservative Arab producers to ease the instability and tension arising from the Iranian revolu-

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tion and the Iran-Iraq war, rather than risk increasing them.

The main exception we see to this rule is the possibility of Libyan action against the US arising from the present tensions in our relations.

In the meantime, oil producers continue to effect changes in the structure of the international market, involving the direct sale of more and more of their oil to smaller buyers, avoiding intermediation by the major international oil companies. This enhances the producer nations' market power, and may enable them in the near future to target the United States for more specifically than in 1973 if they again impose an embargo and production cuts.

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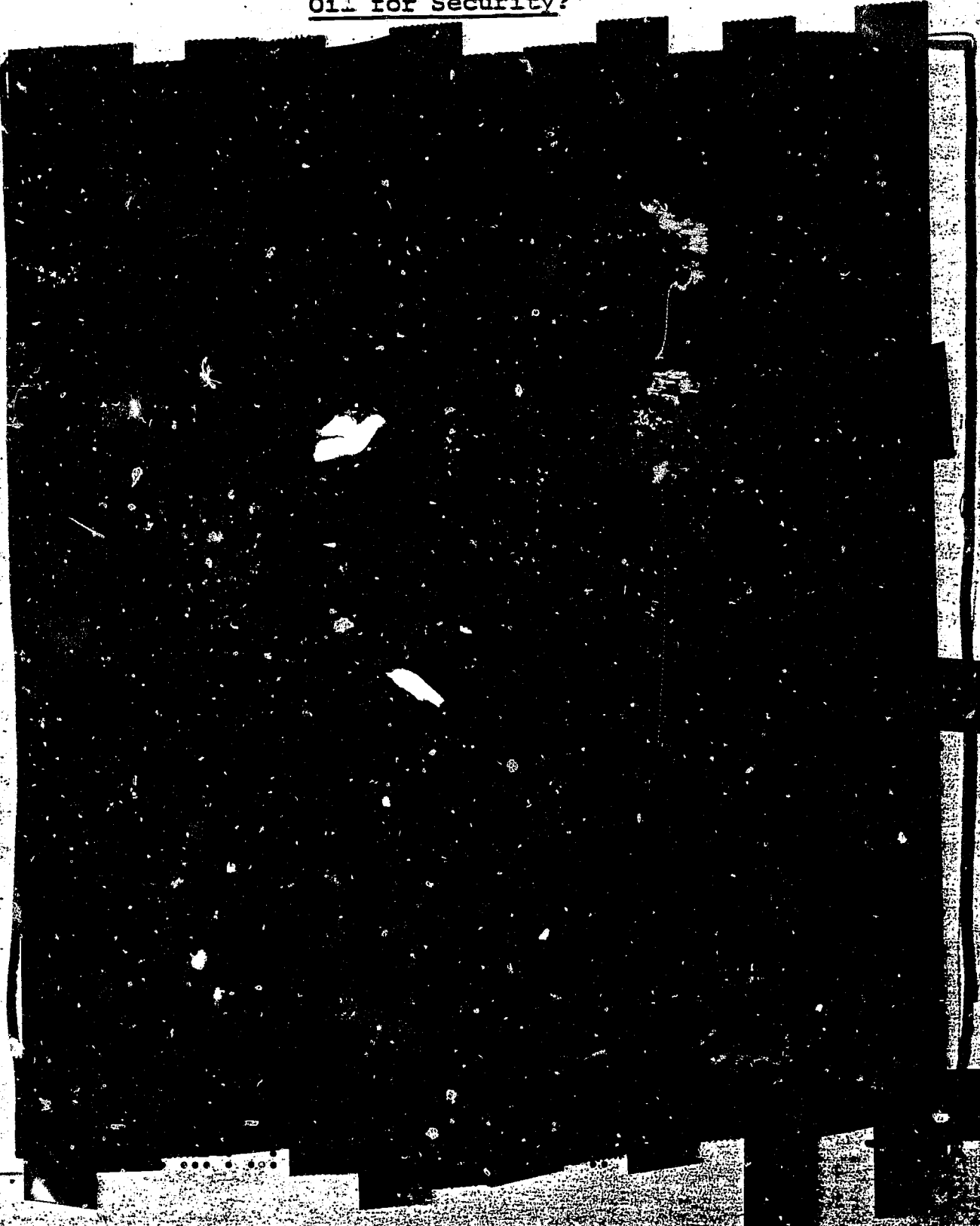
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ANNEX B

Oil for Security?



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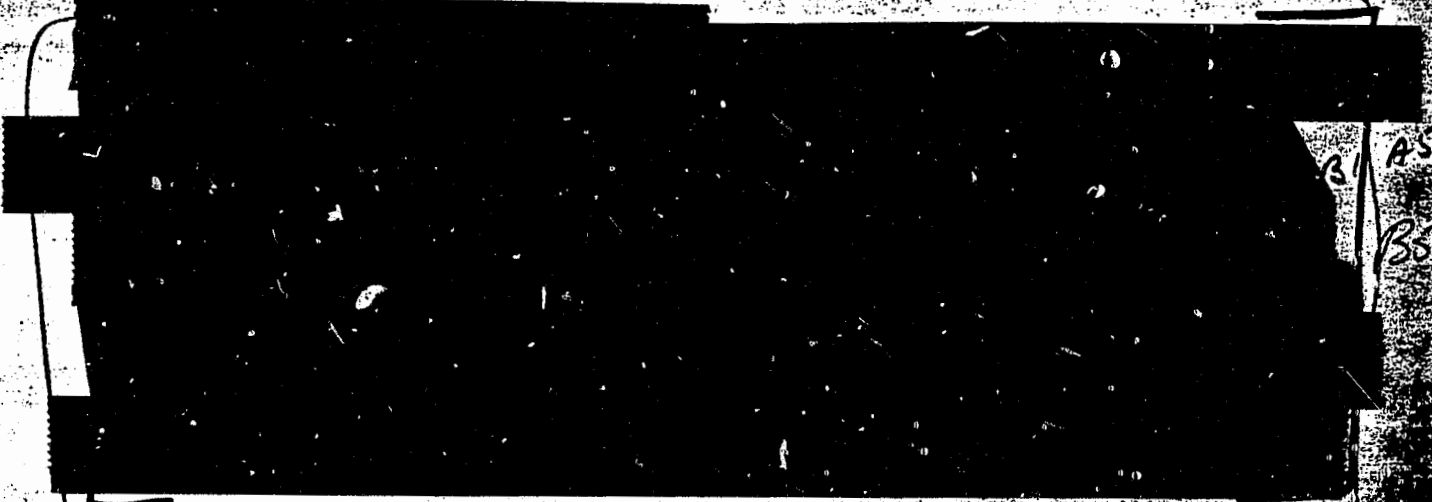
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FINANCIAL IMPLICATIONS

Foreign Asset holdings of Middle East oil exporting countries have nearly doubled in the past year. The steep 1979 oil price rise and sustained high oil production have resulted in revenues which outpace the capacity of these countries to spend on imports. In 1980, a balance of payments surplus on current account in the magnitude of \$90 billion and \$30 billion from investment income are expected to boost net foreign assets of these countries to \$290 billion. Though the oil revenue surplus is expected to diminish in 1981 if oil prices can be kept moderately stable, this massive transfer of financial resources carries important implications for the international economy and financial stability. The Iran-Iraq war impact is yet unclear.

An immediate concern is that the oil exporters' surplus reflects a huge balance of payments deficit on the part of developing as well as developed countries and East Europe which will have financing requirements of nearly \$120 billion this year and \$90 billion next, chiefly to purchase higher priced oil imports. The oil surplus countries have generally shown a preference for placing their assets in commercial banks which are expected to recycle these funds to finance some \$70 billion of the international deficit. The remainder must come from bilateral official development assistance, from multilateral institutions and by deficit countries drawing down their reserve assets. The larger industrial democracies are expected to have little problem financing oil imports. However, this massive dislocation of resources and additional financing costs involved pose a considerable problem for sustaining real world economic growth with financial stability.



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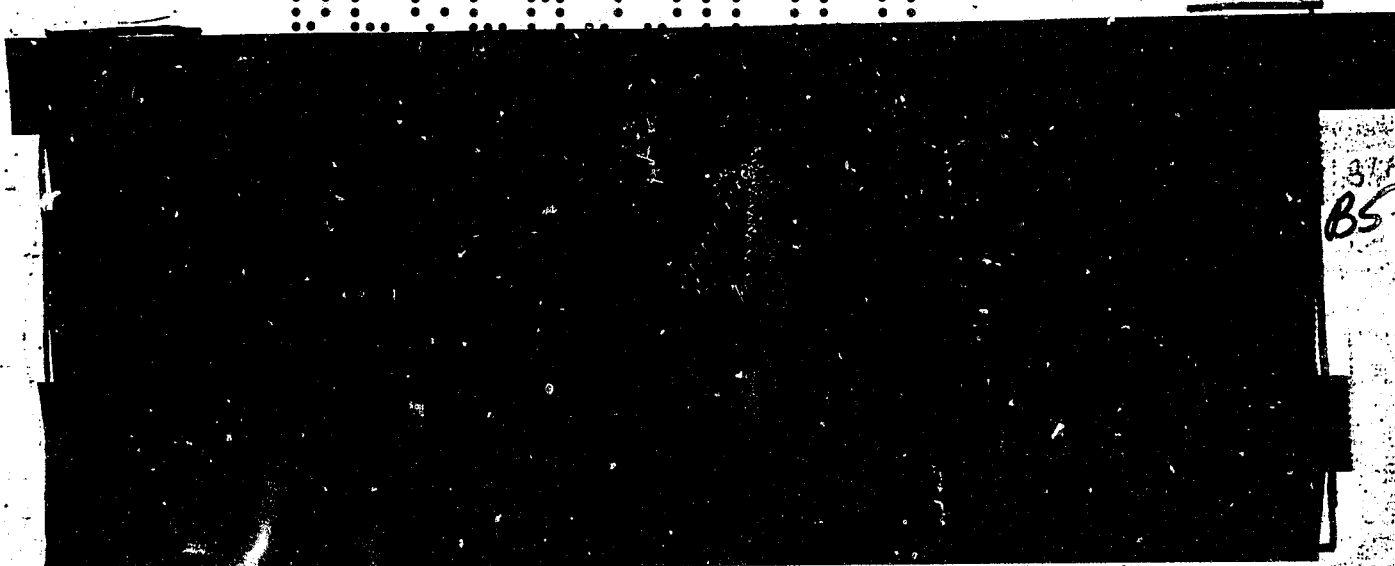
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ECONOMIC AND MILITARY ASSISTANCE IN THE NEA REGION

NEA is the major recipient of U.S. assistance on a worldwide basis, receiving 81 percent of total available Economic Support Funds (ESF), 44 percent of PL 480 agricultural commodities, and 75 percent of total military assistance, chiefly to Israel and Egypt. In the past three years NEA countries received total bilateral economic assistance of over \$2 billion annually. Military assistance averaged \$4 billion annually, 73 percent of which went to Israel.

Additionally, multilateral development agencies, e.g., IBRD, IDA, ADB, UNDP - which rely on U.S. contributions for approximately 25 percent of their resources, have annually committed some \$3 billion to the NEA area in the same period, concentrating on India, Bangladesh, Pakistan, and Egypt.

The Evolving Relationship

The present level of U.S. involvement in the region is an outgrowth of our efforts to foster a negotiated settlement between the front line Arab states and Israel after the 1973 War. Pre-war resource transfers to the region were only 24 percent of total economic and military assistance and focused on four areas - a major commitment to Israeli defense and economic stability; a small defense and development commitment to Jordan; a traditional, albeit minor, development donor role in the Mahgreb states of Tunisia and Morocco; and a traditional and fairly significant donor role in South Asia, particularly in India, Pakistan, and Bangladesh.

Our major assistance outlay has aimed at supporting Israel's security; we will meet increasing demands for this purpose over the short term. Our smaller programs of support to traditional aid recipients in North Africa and substantially larger assistance to the poorer countries of South Asia will be expected by the recipients to continue near current levels. We are giving priority attention to programs which aim at supporting our access to strategic Middle East oil in the crucial Gulf region. This critical issue naturally includes our support of Israel and Egypt. It, however, involves the difficult question of our level of assistance to Pakistan and the need to provide an adequate level of military and technical assistance to the countries of the Gulf and immediate periphery.

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The Arab Israeli Conflict

Since 1973 our focus on the peace negotiations has substantially overshadowed other U.S. assistance efforts, and Egypt has joined Israel as major recipients of ESF allocations. Egypt and Israel have received 65 percent of NEA's total ESF and PL 480 funds in the past three years. Total U.S. economic and military assistance to these two countries have averaged almost \$3 billion annually since 1974. This assistance has helped advance the peace negotiations by providing support in economic and security areas so that Sadat and Begin could feel confident in making difficult concessions. There undoubtedly will be continued demands on U.S. resources from Egypt and Israel as the peace process evolves. The wealthy Arabs have cut off economic assistance to Egypt for signing a separate peace treaty with Israel. Israel's security concerns will increase as it is asked to make further territorial concessions in the face of increasing Arab qualitative advances in military capacity.

Additional assistance requests can be expected because the economies of both countries are burdened with basic structural problems. Moreover, many economic experts believe crucial policy changes are needed soon to avoid aggravation of the situation. Israel is plagued by triple-digit inflation, balance of payments problems, and growing foreign debts stemming from huge defense expenditures and emphasis on pursuing a dual policy of import substitution and export-oriented investment. Egypt, while showing improvement on the macroeconomic side due to increased oil exports, aid, and worker remittances, lacks the essential infrastructure and managerial skill to use all our assistance efficiently. In addition, the government's subsidy policy on basic commodities places an increasing strain on its budget and has exacerbated inflationary pressures. Yet, as the peace process evolves, both governments will expect - and need - continued U.S. support to avoid domestic crises.

North Africa and the Gulf

The U.S. assistance relationship with the region has expanded in complexity as well as size. The increased wealth of the oil states has added another dimension to our assistance programs -- reimbursable technical assistance -- wherein we provide development and quasi-military support services on a cash basis. We have strengthened our ties to Saudi Arabia and

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the Gulf States through our reimbursable development program and military cooperation. We are continuing development assistance and financing military sales in Morocco and Yemen as a part of our effort to stabilize the region. U.S. development assistance in Tunisia is ending in FY 1981, but other programs including PL 480 Title I and housing guarantees will continue. Tunisia has also requested a major increase (\$300 million over 5 years) in U.S. military sales credits (FMS) to enhance their shaky defenses against increasingly potential Libyan aggression. While we may not meet that entire request given budgetary constraints, we have allocated \$30 million in FY 1981 and \$50 million in the FY 1982 budgets for Tunisian military purchases.

South Asia

In South Asia our traditional donor relationship with Pakistan ended in April 1978 in the controversy concerning the Pakistanis' efforts to build a nuclear weapons capability. The furor over this issue led to a Congressional prohibition on U.S. assistance to Pakistan. The Soviet intervention in Afghanistan and the Iran-Iraq War have heightened the danger of regional destabilization. The wealthy Gulf Arabs have promised Pakistan considerable financial help and have made some initial payments. The IMF has also reached an agreement on terms of a three-year program. All donors, however, will be expecting the U.S. to be forthcoming on debt rescheduling and additional assistance to demonstrate our own commitment to Pakistan's security as essential to the region. To take the first step, however, will require the Administration to persuade Congress of the need to lift the nuclear non-proliferation restriction on providing aid.

In India the U.S. has consciously reduced our bilateral donor role since 1971, allowing the multilateral development banks to take the lead in supplying India with development funds. There is a continued need, however, as part of a bilateral commitment to India and an implicit multilateral agreement among the OECD donor consortium to maintain net positive bilateral resource flows to India. To this end we have a modest - given India's size and needs - development assistance program which will total \$150 million in FY 1982.

In Bangladesh, Nepal, and Sri Lanka U.S. development assistance has been crucial to the improvement and growth of each economy. While Bangladesh faces almost insurmountable

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problems of poverty, and scarce resources to support a growing population, it is evident that the steps taken to introduce improved agricultural policies are finally yielding increases in food production. Such progress will need continued U.S. support.

In Nepal and Sri Lanka U.S. assistance in relatively small amounts has stimulated political and economic change. The traditionally conservative Nepalese society has taken important steps toward increasing political participation in the government. Sri Lanka has reversed its socialist orientation to a free enterprise economy with remarkable success. These efforts merit continued U.S. support. The creation of economically viable states in Southwest Asia is an integral element of regional political stability.

U.S. Relations with the Gulf Donors

The U.S. has pressed the wealthy Gulf States to increase their contributions to the multilateral development institutions as well as their bilateral support for countries in which we have mutual interests, e.g., Turkey and Pakistan. While their response has been positive, the Gulf States have in turn suggested we do more on both the bilateral and multilateral aid front. Moreover, they perceive the limited expansion of both our assistance and commercial credit programs as a major obstacle to the dissemination of valuable Western technologies that are vitally needed by the LLDCs and the Gulf States themselves. They have urged the U.S. to expand programs whereby excess capital countries like the Gulf can purchase technology. In response to their needs, we have revamped and broadened the former reimbursable development program under AID into the Trade and Development Program under IDCA. We should perhaps also seek ways to cooperate more directly with the Gulf assistance institutions enabling them to finance more Western technical assistance to LLDCs.

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